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SUBJECT: GOVERNMENT PROPOSES DEVELOPMENT FOCUSED BUDGET FOR FY 08

¶1. Summary: The Bangladesh government released a draft fiscal year 2008 (starting July 1, 2007) budget on June 7. In his budget message, Finance Advisor Mirza Islam identified seven key development and economic growth challenges and the government's plan for meeting those challenges. Agriculture, education, health, power and transportation infrastructure, and information and communications technology were key beneficiaries. The budget proposes a more focused approach to the annual development program, with fewer projects implemented more quickly. Adjustments to tax policy are intended to reduce dependence on import tariffs while increasing the share of revenue from income and VAT taxes. In an important structural change, the budget will finance the outstanding debt of several state-owned enterprises, in particular over $1 billion of debt owed by the Bangladesh Petroleum Corporation to the government owned banks. Conspicuously absent was discussion of the defense budget, which received modest increases over FY 07 expenditures. Business and civil society reaction was generally positive. The final budget will be issued by ordinance following a brief public comment period. End Summary.

¶2. Budget Facts: The government is proposing a $12.44 billion budget for FY08, 30% larger than the revised FY 07 (ending June 30) budget, funded by a near doubling of both domestic borrowing ($2.75 billion) and foreign assistance ($1.7 billion). Revenues are projected to rise 15.8 % through broadening of the tax base, enhanced enforcement, introduction of an improved self-assessment system and limitations on the discretionary authority of tax administrators. While more realistic than the previous budget's 20% projected revenue growth, the FY 08 projections are still 4.5 percentage points higher than the 11.3% growth achieved in the first eight months of FY 07. The projected deficit, including the allowance for the BPC debt, is $4.26 billion, or 5.6% of GDP. The budget assumes 7% real GDP growth, slightly higher than the 6.8% achieved in FY 06. (Political turmoil is expected to limit growth for FY 07 to between 6% and 6.3%.)

¶3. Budget Reflects Interim Government's Priorities: Elections are a key priority. The budget provides a 350% increase in funding for the Election Commission from $17.1 million to $76.6 million, over 50% more than the Commission requested. Funding for the Annual Development Program is up slightly over the original FY07 budget but reflects a 23% increase over the FY 07 revised figure (based on actual expenditures). Historically, actual ADP expenditures are significantly lower than the budget targets, which help offset revenue shortfalls. This year, the government proposes to concentrate on fewer ADP projects and introduce administrative changes to ensure earlier and more complete

implementation. Power and infrastructure (34.4%) and social safety net (34.3%) receive the lion's share of the ADP budget. The government promises to eliminate power shortages by 2010 with nearly 2300 MW of new power generation and increased attention to maintenance and operational efficiency of the installed base. Likewise, the budget includes significant allocations to both add new road and rail infrastructure and address long-neglected maintenance of existing roads and rail lines.

¶4. Social Priorities Also Addressed: Education and religion received the highest share (16.3%) of the total ADP allocation, with funding for 15,000 additional primary teachers, expansion of stipends for poor female and (for the first time) male students, additional classrooms, and pilot jobs-training programs. The budget introduces performance evaluation for non-government schools receiving government teacher salary support and introduces a competitive grant program to promote international standard research at the university level. The budget also increases spending on social welfare, women and youth development, including a pilot stipend program for poor lactating mothers.

¶5. Tackling Inflation: Mirza boldly predicted inflation would moderate to 6.5%. The budget contains modest provisions to reduce the price of essentials, including elimination of tariffs on edible oils, wheat and other essential consumables, subsidies to farmers to offset rising costs for fertilizer and diesel fuel, increased government imports for market stabilization and to support the vulnerable group feeding program, and development of additional wholesale markets to increase efficiency in the distribution chain. Mirza stressed, however, that many of the factors contributing to higher inflation were beyond the

scope of the budget.

¶6. Down Payment on Structural Imbalances: Responding to longstanding IMF recommendations, the budget proposes to gradually eliminate below-market energy pricing by the state-owned energy companies and transfer their liabilities to the national budget. The budget includes various income support mechanisms to cushion the impact of rising energy prices on the poor. The most significant impact is the recognition of the $1.08 billion debt of the Bangladesh Petroleum Corporation to the national commercial banks (NCBs). The financing of this debt is the principal cause of the projected increase in domestic financing. The immediate monetary impact should be minimal (this is the recognition of a pre-existing debt, not new spending) and is a positive change in the government's fiscal transparency. Addressing the BPC debt to the NCBs should also facilitate ongoing IMF supported efforts to privatize the NCBs. The budget also proposes public trading of the shares of the state-owned enterprises both to bolster the capitalizations of the country's two stock exchanges and to introduce greater accountability into the organizations. The budget addresses regional development imbalances by directing a larger share of development funds to the three less developed western divisions.

¶7. Business Gets Few Perks: The budget was largely neutral for business, with most of the impact coming from tax changes. The top tariff slab remained 25% but the other two slabs increased from 5% to 10% and from 12% to 15%. The 4% infrastructure surcharge was eliminated, in many cases offsetting the tariff increases. Some business deductions were liberalized while withholding provisions were strengthened. Taxes based on gross revenues were halved. The list of goods and services subject to VAT was expanded while procedures for calculating and assessing VAT were streamlined. Funding to support development of the information and communications technology sector increased 21%. Funding for SMEs, worker training and support in the ready-made garment sector, agricultural research, and other

business incentive funds saw modest increases. For most businesses, the real impact lies elsewhere in the budget's emphasis on infrastructure and human capital development.

¶8. Military Slice Modest: The FY 08 budget includes $768 million (5.6%) for defense spending, up 11.5% from the original FY07 budget but a mere $11 million (1.4%) above projected FY 07 expenditures. The government did not provide a breakdown of military spending.

¶9. Public Reaction Positive: Business leaders generally welcomed the budget proposal, while cautioning that implementation would be challenging. Although winners and losers quibbled over specific tax changes, no one challenged the overall approach. Civil society analysts also reacted favorably to the budget while expressing similar concerns over implementation.

¶10. Comment: The FY 08 budget is a serious attempt to address longstanding economic and social development needs. It is reasonable to think the government will achieve its goal of earlier and more complete implementation of its planned annual development program expenditures, as these are largely within the government's control. The risk is that the corresponding revenue and donor assistance growth needed to fund those expenditures, over which the government has significantly less control, will as in the past fall well short of budget projections. The additional budget shortfall could significantly expand an already large budget deficit, undermining macroeconomic stability and the government's efforts to combat inflation while fostering stable economic growth. End Comment.
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